MAR 5 1956
HAROLD B. WILLEY, Clerk

IN THE

Supreme Court of the United States

No. 733

OCTOBER TERM, 1955

WESTERN MARYLAND RAILWAY COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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- Section 113(a) 3, 14
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Western Maryland Railway Company prays that a writ of certiorari be issued to review a judgment of the United States Court of Appeals for the Fourth Circuit, affirming a judgment of the United States District Court for the District of Maryland in favor of the defendant, in an action by Petitioner for the recovery of excess profits taxes.

OPINIONS BELOW

The opinion of the District Court, which is quoted in full beginning at page 3 of Petitioner's appendix as printed for the Court below, is reported at 131 Fed. Supp. 873.

The opinion of the Court of Appeals is printed in full as Appendix "A" to this petition, and is reported in 227 Fed. 2nd 576.

JURISDICTION

(i) The judgment, review of which is sought, was dated and entered in the United States Court of Appeals for the Fourth Circuit on December 6, 1955.

(ii) There has been no order granting or denying rehearing in the Court below, or extending the time within which to petition for certiorari.

(iii) The jurisdiction of this Court is invoked under Title 28, United States Code, Section 1254(1) and Section 2101(c).

QUESTION PRESENTED FOR REVIEW

Can Section 718(a) of the Internal Revenue Code of 1939 requiring that equity invested capital *"shall be the sum of"* money paid in and property other than money paid in, and the regulations applicable thereunder, be construed to permit the Commissioner of Internal Revenue to make a lawful determination of equity invested capital without determining the "sum of" these elements?

STATUTES AND REGULATIONS INVOLVED

This petition involves the construction and proper application of the following provisions of the Internal Revenue Code of 1939 and regulations relating to the determination of equity invested capital.

> "Sec. 718. (a) DEFINITION. — The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—
>
> > (1) MONEY PAID IN. — Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) PROPERTY PAID IN. — Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. * * *"

(See 26 U. S. Code Annotated, Excess Profits Taxes, Section 718).

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY. — The basis of property shall be the cost of such property; * * *"

(Internal Revenue Code of 1939, 26 U. S. Code, 1952 Ed., Sec. 113(a)).

"Reg. 112, Sec. 35.718-1. Determination of daily equity invested capital — Money and property paid in. — The equity invested capital for any day is determined as of the beginning of such day. The basis or starting point is found in the amount of money and property previously paid in for stock, or as paid-in surplus, or as a contribution to capital. The terms 'money paid in' and 'property paid in' do not include amounts received as premiums by an insurance company subject to taxation under section 204. For the purpose of determining equity invested capital, the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. * * *"

"If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance. * * *"

(C. C. H. Excess Profits Tax Reporter, 1946, Vol. 3A, Sec. 5087).

STATEMENT OF THE CASE

Petitioner brought three actions[1] in the United States District Court for the District of Maryland against the United States for recovery of excess profits taxes which it alleges were unlawfully collected for the taxable calendar years 1943, 1944 and 1945. The District Court had jurisdiction over these actions under Title 28 U. S. C., Section 1346(a)(1).

The actions charged that the excess profits credit allowed to Petitioner by the Commissioner of Internal Revenue for the years 1941 to 1946, inclusive, was incorrectly determined because, among other things, the Commissioner failed to include in Appellant's equity invested capital $6,274,160 of money paid in which should have been included in computing Petitioner's excess profits credit. This resulted in the payment of excess profits taxes for the years 1943, 1944 and 1945, which Petitioner alleges were excessive by more than $2,500,000.[2]

The parties stipulated in the trial court that the correctness of the Commissioner's determination depends upon the effect on Petitioner's equity invested capital of a reorganization effective January 1, 1910, in which the railroad and *property* of Western Maryland Rail *Road* Company (hereinafter sometimes called "the old company") was conveyed to Petitioner's immediate predecessor, *The* Western Maryland Rail*way* Company (hereinafter sometimes called "the new company") in exchange for its preferred and common

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[1] These actions were consolidated for trial and were heard on appeal on a single record.

[2] The amount of additional taxes and interest paid by Petitioner are stated at page 45 of Petitioner's Appendix in the Court below. Computation of the extent to which these amounts constitute overpayments, and the interest thereon, has by agreement been postponed until after final decision in these cases (Petitioner's Appendix, page 20).

stock, and accompanied by payment by the bondholders and stockholders of new *money* capital to the new company (Appendix[1] 19, 47).

On March 5, 1908 a receiver was appointed for Western Maryland Rail Road Company, the "old company", when it became apparent that it would be unable to meet the interest due April 1, 1908 on its $10,000,000 of General Lien and Convertible 4% Bonds.

A protective committee was immediately formed (Exhibit 1, Appendix 49) which solicited and obtained deposit of the defaulted bonds at The Equitable Trust Company of New York, the designated depositary of the committee. The depositary issued negotiable Certificates of Deposit to the bondholders. The committee was authorized to prepare a reorganization plan (Appendix 56-7), and was given "discretion" by the depositing bondholders to "recognize and make provision for the stock of said railroad company" (Appendix 67). Accordingly the plan, instead of leaving the stockholders of the old company out, took note of "the equity represented by the old common stock" (Appendix 71) and thereupon included the old stockholders as well as the old bondholders in the reorganization provisions.

The plan of reorganization, insofar as is material here, provided:

> (1) That the property of the old company would be transferred by means of foreclosure of the mortgage underlying the defaulted General Lien and Convertible Bonds, to a newly organized company (the "new company") which would issue $10,000,000 of $100 par value new preferred stock, and $23,959,560 of $100 par value

[1] Unless otherwise indicated all references are to exhibits and page numbers as they appear in Petitioner's Appendix as printed for the Court of Appeals.

new common stock "* * * in acquisition of the *property* of the old company * * *" (Appendix 67-8).

(2) That $8,274,160 of new money capital required to support the plan would be raised from the old stockholders and bondholders as described below (Appendix 67-8).

(3) That the $10,000,000 of new preferred stock would be issued in exchange for the Certificates of Deposit for the defaulted General Lien and Convertible Bonds (Appendix 68).

(4) That $15,685,400 par value of the new common stock would be issued to the old common stockholders "in exchange for their old common stock and on payment" of $40 per share "in cash" (Appendix 68). This cash payment would provide $6,274,160 of the required new money.

(5) That $5,000,000 par value of the new common stock would be sold to the old bondholders at $40 per share, each $1,000 Certificate of Deposit entitling the holder to purchase $500 par value of the new common stock (Appendix 68). This would raise $2,000,000 of the new money required.

(6) The remaining $3,274,160 par value of new common stock was to be issued for defaulted interest coupons on the General Lien and Convertible Bonds ($836,000), and for "expenses of the reorganization, compensations, underwriting and other commissions and for reserve" ($2,438,160) (Appendix 70).

The stockholders of the old company accepted the proposals of the plan by depositing their stock, endorsed for transfer, with the committee's depositary, The Equitable

Trust Company of New York, receiving negotiable Deposit Receipts as evidence of the transaction (Appendix 82). They also paid to the depositary for the account of the new company, as the Government conceded at the trial (Appendix 184-7), the $6,274,160 in new money.

The holders of Certificates of Deposit for the defaulted General Lien and Convertible Bonds, were, of course, already committed to the committee's reorganization plan by the deposit of their bonds, subject to their right to dissent or withdraw (Appendix 58-9). They did not dissent and paid in the $2,000,000 in new money as the price of the common stock sold to them (Appendix 128-9, 184-7).

The reorganization plan was carried out as proposed, and the new company, as of January 1, 1910 (Appendix 30) took over the old company's property, issuing its $10,000,000 of preferred stock to the holders of Certificates of Deposit for the defaulted General Lien and Convertible bonds, and $15,685,400 of its common stock to the holders of Deposit Receipts for the common stock of the old company (Appendix 12, 128, 148). The balance of the new common was also issued in accordance with the plan.

On these facts the Commissioner of Internal Revenue determined that Petitioner's equity invested capital consisted only of 10,000 shares of preferred stock having a fair market value of $7,000,000, and 239,595.6 shares of common stock having a fair market value of $12,518,870.10 (Appendix 48). His notification to Petitioner of his final determination of its equity invested capital is as follows:

COMPUTATION OF ADJUSTMENT TO INVESTED CAPITAL IN CONNECTION WITH THE 1909-10 REORGANIZATION

New Preferred & Common Stock is included as follows:	
100,000 shares new 4% Preferred issued for $10,000,000 defaulted General Lien and Convertible bonds 100,000 at $70[1]	$ 7,000,000.00
New $100 par Common:	
In exchange for old Common stock 156,854 at $52.25[1] per share	8,195,621.50
To General Lien & Convertible Bondholders on payment of $40 per share 50,000 at $52.25 per share	2,612,500.00
To General Lien & Convertible Bondholders for overdue interest 8,360 at $52.25 per share	436,810.00
To Reorganization Committee for Commissions and expenses 24,381.6 at $52.25	1,273,938.60
TOTAL	$19,518,870.10

(Appendix 24)

[1] The Commissioner fixed $70 per share as the fair market value of the new preferred stock, as of January 1, 1910, and $52.25 per share as the fair market value of the new common stock at the same time (Appendix 3).

It will be observed that in the foregoing notice the Commissioner included in Petitioner's equity invested capital the sum of $2,000,000 of money paid in by the holders of the Certificates of Deposit for the defaulted General Lien and Convertible Bonds (third item of the notice), although he treated the stock issued for this money as if it had been issued for property other than money, by determining its fair market value. But the sum of $6,274,160 in money admittedly (Appendix 184-5) paid in by the holders of

Deposit Receipts for the common stock of the old company, at the same time the bondholders paid in their money, and to the same depositary (Exhibit 5, Appendix 81), was not included in Petitioner's equity invested capital.

So far as is material here, the Petitioner contended in the Courts below that under the statute and the regulations (quoted supra page 2) these preferred and common stocks could be included in its equity invested capital at their fair market valuation, only as being the measure of the cost of acquiring the property, other than money, of the old company. Therefore, the amount determined by the Commissioner for "new $100 par Common: In exchange for old Common stock * * *" (Second item of the notice) represented, and correctly under Section 718(a)(2), the *property other than money* paid in by the old common stockholders, namely, the interest which they had retained in the assets of the old company through the deposit of their shares under the reorganization plan. Since Section 718(a) says perfectly clearly that equity invested capital shall be the "sum of" money *and* property other than money paid in, Petitioner contended that it is entitled to have the *money* admittedly paid in by the old common stockholders ($6,274,160) also included in its equity invested capital, as money paid in for stock, or as a contribution to capital under Section 718(a)(1).

The Government contended that the foreclosure wiped out the common stockholders (despite the fact that the reorganization plan recognized that they had an equity in the old company, and preserved it by expressly including them with the bondholders in the reorganization, through deposit of their shares under the reorganization plan); that the new common stock was issued to the old stockholders only for money paid in in the amount of $40 per share, because the old common stockholders had no equity in the

old company and, therefore, had nothing to pay for the new stock except the money (despite the fact that the plan of reorganization expressly said that they "shall pay for the same by surrender and transfer of their shares of old stock in said Western Maryland Rail Road Company in equal par amounts, and payment of $40 per share for the new stock * * *" (Appendix 82)); therefore, when the Commissioner of Internal Revenue included in equity invested capital the new common stock issued to the old stockholders at its fair market value on January 1, 1910 ($52.25 per share), he allowed more than Petitioner was entitled to, because the stock should have been considered as issued for money only and, consequently not more than $40 per share, or $6,274,160 total, should have been included in equity invested capital on account of this stock.

The District Court decided (Appendix 37-40) that the money paid in to the Reorganization Committee by the holders of Deposit Receipts for the old common stock, and Certificates of Deposit for the defaulted General Lien and Convertible Bonds, had the effect of improving the fair market value of the new common stock. Consequently, when such improved fair market value was determined as Petitioner's equity invested capital to the extent represented by common stock, it "included the $40 per share cash which was paid in" (Appendix 38).

The Court of Appeals in a per curiam opinion simply stated that the District Court had properly decided against Petitioner on this issue (Page 18, post.)

ARGUMENT

I.

This petition brings up an important question of Federal Tax law which should be, but has not been settled by this Court.

The proper application of the statutory directions for determining a correct excess profits credit, is, of course, fundamental, and is the starting point for the calculation of excess profits tax liabilities.

An interpretation of the requirements for ascertaining an excess profits credit, under the invested capital method, which permits the Commissioner to defeat the express language of the statute, should not be tolerated. That is to say, if the Commissioner can defend his failure to calculate the "sum of" such elements of equity invested capital as are present in any instance, by merely asserting that one element is included in another (even when the statute specifically says that element may not be included), the statute is easily set at naught and taxpayers may be required to pay large sums of money not due.

The decision in this case would make such a result possible, and this may furnish the Commissioner with an effective means of justifying almost any equity invested capital determination.

This is certainly not the way in which the meaning of Section 718(a) has been viewed by the lower Courts so far.

For instance, in *Black Hills Power and Light Company* (1950) 14 T. C. 1425, the Tax Court held that the Commissioner could not lump all the steps of a reorganization together and arrive at the conclusion that equity invested capital consisted only of money paid in. The Court said:

> "Section 718(a) provides that equity invested capital shall include money paid in for stock *and also* property other than money paid in for stock. (1426) * * * Since property was actually paid in for the stock, that property *must be* included in equity invested capital 'in an amount equal to its basis (unadjusted) for determining loss upon the sale or exchange'." (1427) (Italics ours.)

If property, other than money, actually paid in "must" be included in equity invested capital to satisfy the requirements of Section 718(a), then certainly money actually paid in is an equally necessary element.

In *Tennessee Products Corporation v. United States* (1952) 107 Fed. Supp. 578, the Court of Claims said that the Commissioner could not treat a reorganization so as to omit including property paid in in his calculation of taxpayer's equity invested capital.

And in *San Marcos Hotel Company v. Commissioner* (1953) 205 Fed. 2nd 641, the Court of Appeals for the Ninth Circuit obviously regarded the statute literally when it said "equity invested capital is defined as the *sum of* money *and* other property paid in for stock, or as paid in surplus or as a contribution to capital * * *". (Italics ours.)

So far as Petitioner is aware this Court has rendered only three decisions upon the World War II Excess Profits Tax. *Commissioner v. South Texas Land Company* (1948) 333 U. S. 496 involved the treatment of instalment sales in the determination of the accumulated earnings and profits element of equity invested capital, which was described by the Court as a matter "of importance in tax administration." *U. S. v. Koppers Company* (1955) 348 U. S. 254, decided the question of when an abatement under Section 722 is effective, about which the lower courts were in conflict.

The other case (*Brown Shoe Company v. Commissioner* (1950) 339 U. S. 583) is more fully referred to later.[1]

A decision upon whether Section 718(a) means what it says, or may be so interpreted that equity invested capital is not "the sum of" the prescribed elements, but as a practical matter is whatever the Commissioner determines it to be, is certainly of equal importance with the subjects already decided. Petitioner submits that whether Section 718(a) is thus in effect a nullity, is a matter of tax law of sufficient importance to be considered and ruled upon by this Court.

II.

The decision below is in conflict with the way in which Section 718(a) of the Internal Revenue Code of 1939 has been construed by this Court.

In *Brown Shoe Company v. Commissioner*, (1950) 339 U. S. 583, the Commissioner of Internal Revenue had determined that money and property contributed to a corporation could not be included in its equity invested capital "as a contribution to capital", unless the owners of the business, that is the stockholders, were the source of the contribution. This Court rejected this "constricted" concept of capital, observing that the transfers to the corporation "manifested a definite purpose to enlarge the working capital of the company" (339 U. S. 591). This Court thus decided that Section 718(a) should not be narrowly construed to prevent a taxpayer from including in its statutory equity invested capital "values which are properly 'treated as his investment' " (339 U. S. 592).

[1] We note that in all of these cases certiorari was granted after repeal of the World War II Excess Profits Tax, that in the Koppers case being as late as June 1, 1954.

The present petition brings to this Court another instance in which a "constricted" construction has been given to Section 718(a), and which clearly has the effect of excluding from equity invested capital, assets (money) necessarily designed to "enlarge the working capital of the company".

Section 718(a) of the Internal Revenue Code to the extent here material, provides that equity invested capital "shall be the *sum* of the following amounts:

> (1). "MONEY PAID IN — Money previously paid in for stock, or as paid in surplus, or as a contribution to capital";
>
> (2) "PROPERTY PAID IN — Property (other than money) previously paid in (regardless of the time paid in) for stock, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange * * *."

This obviously means that *both* money *and* property other than money are *required* to be included in the determination of equity invested capital if both are "paid in". And in order that there can be a "sum" of the two elements, each must obviously be separately considered and valued.

"Money" paid in is accounted for as money at its dollar value. The statute for obvious reasons provides no special means for determining the value of "money".

"Property (other than money)" paid in, on the other hand, presents a question of ascertaining its value, and the statute provides that it is to be included at its basis for determining "loss upon sale or exchange". On referring to Section 113(a) of the Internal Revenue Code of 1939, it will be found that "the basis of property shall be the *cost* of such property", unless one of some twenty-two exceptions to the cost basis applies. The Government agreed with

Petitioner in the courts below that none of these exceptions are applicable to the facts of this case. Consequently "cost" is the basis to be used, and Regulations 112, Section 35.718-1, which prescribes the means for application of Section 718 (a)(2) provides:

> "For the purpose of determining equity invested capital, the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. * * *
>
> "If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance. * * *"

It is obvious from these provisions that not only are money and property other than money required by the language of the statute and regulations to be separately included in equity invested capital, but the method of determining the effect of each on equity invested capital necessitates that they be separately ascertained.

Despite the plain effect of the law and regulations, the Court below has held that equity invested capital need *not* be the "sum of" the money and property paid in. Under its decision, although money is actually paid in, a determination made for property other than money paid in, valued in accordance with the regulations at its cost in terms of the fair market value of stock issued to acquire such property, may be the sole element of equity invested capital, thus setting the statute at naught. Money admittedly paid in with the "definite purpose to enlarge the working capital of the company" may be excluded from equity invested capital by the device of describing it as merely a portion of the cost of property paid in even though the statute says this element must exclude money. This is plainly contrary to the principles announced by this Court in the *Brown Shoe Company* case.

CONCLUSION

This petition seeks a decision from this Court that Section 718(a) means what it says, and that the Commissioner of Internal Revenue *must* include in equity invested capital "the sum of" the elements defined by the statute, when the facts disclose them to be present. The cost of *property other than money* paid in, which is its value for equity invested capital purposes in most instances, obviously cannot, consistently with the language of the statute, also measure the amount of *money* paid in. The two elements are essentially different in nature and for that reason were separately provided for in the statute. The decision below treats them as if they were identical although the statute specifically says they cannot be identical.

Petitioner submits that this is a basic misconstruction of the statute on a matter of fundamental importance in excess profits tax administration. It is at variance with the accepted construction of the statute in other cases.

Respectfully submitted,

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Baltimore, Maryland

March 2, 1956

APPENDIX A

UNITED STATES COURT OF APPEALS
For the Fourth Circuit

WESTERN MARYLAND RAILWAY COMPANY, *Appellant*,

v.

UNITED STATES OF AMERICA, *Appellee*.

(Three Cases)

Nos. 7081-7083

(Argued November 14, 1955. Decided December 6. 1955.)

Before PARKER, Chief Judge, and SOPER and DOBIE, Circuit Judges.

PER CURIAM:

These are appeals by the Western Maryland Railway Company from adverse judgments in suits instituted to recover an alleged overpayment of excess profits taxes for the years 1943, 1944 and 1945. The claim of taxpayer in each case is based upon the contention that the Commissioner of Internal Revenue failed to include a sufficient amount in equity invested capital. The controversy relates to an equity reorganization of the Western Maryland Railroad occurring in the years 1909 and 1910, when the taxpayer purchased property of the prior corporation from a reorgani-

zation committee, assuming all the indebtedness of the old company superior to its general lien mortgage and issuing common and preferred stock in payment. The facts are fully and accurately stated in the opinion of the District Judge and need not be repeated here. See Western Maryland Railway Company, 131 F. Supp. 873.

Three questions are presented by this appeal: (1) Where the holders of common stock or general lien bonds of the old company paid to the reorganization committee $40 per share for common stock of the old company for which the new company exchanged its common stock share for share, was the taxpayer entitled to have the $40 per share included in equity invested capital in addition to the $52.50 per share as the value of the new shares, which was the amount allowed by the Commissioner? (2) Was the taxpayer entitled to have included in its equity invested capital the amount by which the general lien bonds of the old company (the payment of which was not assumed by the new company) exceeded in value the preferred stock of the new company exchanged therefor? and (3) should the preferred stock of the new company issued to the holders of general lien bonds have been valued at $73.50 per share instead of at $70 per share, as valued by the Commissioner? We think that all of these questions were properly answered in the negative for reasons adequately stated in the opinion of the District Judge. The only one as to which there could be any reasonable question is the one last mentioned, relating to the value of the preferred stock; but in view of the facts in evidence and the determination of the Commissioner, which is presumptively correct, we do not think that we would be justified in disturbing the valuation placed thereon by the District Judge. Furthermore, the difference, if allowed, would amount to only $350,000; and this would not help taxpayer, since the Commissioner allowed $1,273,938.80 for stock issued for commissions and services in the reorganization, which is not properly includible in the equity invested capital of the new corporation. *Bard-Parker Co. v. Commission*, 2 Cir. 218 F. 2d 52, 58; *Gabriel Co. v. Commissioner*, 6 Cir. 186 F. 2d 786; *Warner Co. v. Commissioner*, 11 T.C.

419, 433, aff. 3 Cir. 181 F. 2d 599; *Palomar Laundry Co. v. Commissioner*, 7 T.C. 1300; *La Belle Iron Works v. United States*, 256 U. S. 377, 389-390. As the suits in the court below were instituted on the theory that there had been an overpayment of excess profits taxes during the years in question because taxpayer had not been allowed a sufficient amount as equity invested capital, it would be proper to consider that stock issued for services was improperly included in that item if any other item included therein should be increased in amount.

Affirmed.